Brooklyn Law Review

Volume 64
Issue 3
Symposium:
Getting Ready for Individually Managed Pensions:
A Global Perspective

Article 15

3-1-1998

Commentary

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INDIVIDUAL RESPONSIBILITY FOR THE INVESTMENT OF RETIREMENT SAVINGS: A CAUTIONARY VIEW*

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These papers, including ones presented earlier this morning, raise questions about an adequate regime of consumer protection in an era in which responsibility for retirement savings and investment decisionmaking is being devolved, increasingly, to individuals. This shift to individual responsibility has also characterized many Social Security reform proposals, previously a bedrock system of publicly-determined benefit levels. I find this devolution troubling; I think it is odd for individuals to have this responsibility. Individuals are not good risk bearers of market volatility, both in a financial sense and in a psychological sense. The consequence is that unless individuals are locked into all-equity portfolios, as Professor Weiss has suggested, they are likely to pick inefficient portfolios that will not serve their long-term interests. The evidence from current investment of 401(k) plans and other self-directed regiment plans is that individuals tend to underweight equity and correspondingly overweight fixed-income securities despite long-term horizons

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 The following discussion is presented in its original transcript format, with minor editorial changes by the Author.

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of retirement savings. Thus, under present institutional arrangements, the devolution trend is likely to erode the retirement security and comfort of tomorrow's retirees.

Individuals are particularly poor at assessing and bearing the intertemporal risks that arise because of the comparative volatility of stocks versus bonds. This is true even if an individual can appreciate that an all-equity portfolio will over time almost certainly outperform an all-bond portfolio (and outperform a mixed portfolio). (This superior performance of equity portfolios over ten or fifteen year time periods has been the historical experience in U.S. financial markets for more than a century. The past does not predict the future, of course, but in the end, no investment is "risk free.") The individual faces volatility risk of uncertain dimension and is likely to choose a portfolio overweighted in debt, reasoning thusly: "Even if on average, stocks return more than bonds, I retire at particular point in time; what will happen to the market value of my (all equity) portfolio in the face of a market collapse? Perhaps the market will rebound eventually, but in the meantime I will be spending down the now-depressed value of principal. Therefore, I will protect against that volatility risk by investing heavily in bonds." Additionally, and no less potently, the psychological evidence is that individuals will overvalue losses relative to gains of equal size. This problem of "loss aversion" makes it more difficult to invest in stocks, where the daily fluctuations are widely reported, than in bonds or other fixed income securities, where the fluctuations are less and often simply not reported. (Try getting a bank to mark-to-market a certificate of deposit or a guaranteed investment contract.)

These reflections recall the famous essay of twenty years ago by then-Professor now Dean Clark that mapped out the four stages of investment management.[1] The general theme is that the widening of the distribution of ownership of the beneficial claims of securities has been accompanied by greater specialization of the investment function. The first stage is characterized by the individual entrepreneur. Management is centralized and beneficial ownership is centralized because the

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[1] Robert C. Clark, The Four Stages of Capitalism: Reflections on Investment Management Treatises, 94 Harv. L. Rev. 561 (1981).

entrepreneur owns and controls it all. In the second stage, ownership is separated from business management (in Berle-Means terms, the separation of ownership and control). In this stage, capital comes in from dispersed investors who play no role in the business, and the manager will not necessarily have a large ownership stake. In stage three, what we might now think of as the rise of institutional investors, "ownership" is divided between those who supply capital (and who are beneficial owners) and those who provide investment management. Institutional investors serve as financial intermediaries collecting capital from dispersed investors and in turn invest it in specific companies. The capital suppliers make neither managerial decisions over portfolio composition nor over the portfolio companies in which they may be deemed to have some beneficial stake.

Stage four is the crucial stage for our purposes. Clark foresees the division of the "capital supplier" into the "savings planner" on the one hand and the "beneficiary" on the other. This stage gives beneficial ownership its widest distribution, including all those who participate in retirement plans, even while specialization pushes decisionmaking responsibility for capital supply and investment management further away from such beneficiaries. This is the subject of our conference: the contours of this stage of capitalism with respect to savings planning decisions and beneficial ownership.

It turns out that Dean Clark's sketch of stage four was based on an incorrect premise. His conception was based, in effect, on defined benefit plans, where firms were doing the savings and investment planning on behalf of employees, and firms were bearing the risk. Individuals were the beneficiaries through their retirement benefits so the necessary regulatory system was a consumer protection regime to guard against, for example, bad investment decisionmaking by the firm and pension plan insolvency. Clark did not foresee that employees would actually be bearing the risk of their investment choices and, indeed, accepting responsibility for making them. The "fourth stage" now seems to entail a merging of some of the investment functions that Clark imagined that specialization in skill and risk-bearing capability would further separate.

This new enthusiasm for devolution of risk bearing and responsibility to individuals appears not just in the United States but also in the U.K., as we have heard, and in other places, and it may animate the various privatization proposals for Social Security. It appears as part of a general social thrust to shift risks to individuals, the disintermediation of risk. Think, for example, of our changing attitudes about employee layoffs in terms of shifting the risk of economic change or depreciation of human capital investments from firms to individuals. Assuming that there is no great wealth transfer underway, it must be that gains from reduction in moral hazard (the greater incentives that employees face to keep skills fresh and relevant and job motivation high) overcome the losses in comparative risk-bearing capacity. It is a grand social experiment, facilitated at least in the U.S. by rising stock markets and low unemployment levels and may be politically sustainable only in such an environment.

Clark's reliance on the defined benefit plan as a keystone to the fourth stage makes it worth reflecting upon defined benefit plans, now in disfavor. Defined benefit plans have some very desirable attributes. For one thing, such a plan efficiently addresses the retirement income problem because its goal is to provide an annuitized payout without the confounding bequest motive. Defined benefit plans are partially an insurance vehicle so that a beneficiary (including survivors) who dies early does not collect (and cannot pass on) the full value of accrued contributions, but that of course increases the payouts for all others. A defined contribution plan, although also a "retirement" plan, provides not only retirement income but a bequest of the remainder interest. The replacement of the insurance feature with a bequest feature reduces retirement income and security, yet seems almost an accident of the devolution of risk bearing from firms to individuals. The defined benefit plan is also particularly attractive because the benefit stream increases with the employee's salary over time and is keyed to the employee's peak earnings years. Assuming salary is influenced by a growing economy and greater firm profits, this payout structure could be a vehicle for employee gainsharing in the firm's prosperity.

The defined benefit plan began to fall apart in the 1970s. High inflation undercut the actuarial funding assumptions, because the higher salaries (and thus the higher payout obligations) came not from an increase in productivity or profitability but because of increases in nominal wages. From the employee perspective, as job mobility becomes more important, the problems in a defined benefit plan of vesting, portability, and tacking become more serious. The defined benefit plan typically links payouts to the number of years with the particular employer, so an employee who switches among employers will receive less in total benefits than an employee earning the same pay level throughout but who has worked for a single employer. Unlike vesting, this problem has not been solved. This anomaly is an argument in favor of defined contribution plans, which naturally build in full portability, but notice again the cost entailed to the individual by the shift of risk of a shortfall in investment performance. This risk falls on individuals of quite different economic sophistication and quite different apparent risk appetites. The consequence, of course, is that individuals who hold the same job and earn the same salary may receive significantly different retirement incomes after they retire because of portfolio allocation choices whose implications they only dimly understand.

In a recent article, *Employees, Pensions and the New Economic Order*,[2] I attempt to address some of these problems by proposing a regulatory innovation to encourage employees to invest defined contribution assets in the optimal all equity portfolio. Employees need access to a financial vehicle that will provide a hedge against the timing risk of converting an all equity portfolio into a retirement annuity. Such a vehicle should be possible to construct. Employees contribute to pension accounts over time and retire over time; expected returns from stocks are higher than expected returns from bonds. It should be possible for a financial institution to aggregate age cohorts and to pool the intertemporal gains and risks of holding an all equity portfolio so as to improve on the portfolios that most individual will create for themselves, either because of a rational response to volatility risk or

[2] 97 Colum. L. Rev. 1519 (1997).

because of heuristic mistakes. The goal is to create a self-funding insurance scheme, what might be called a "pension equity collar," in which participants give up some of the potential upside of an all-equity portfolio in exchange for protections against the downside. The stability of returns would be enhanced by the capacity to transfer funds across cohorts as part of the intertemporal insurance and by the continued contribution of employees who have not yet retired.

In a sense, this proposal tries to capture for employees in defined contribution plans some of the risk-sharing elements of defined benefit plans. Companies can invest pension fund assets in ways that take advantage of the greater average returns of stock because the intertemporal character of employee claims and contributions buffer the volatility risk. Defined contribution plans presently expose individuals to this risk, but it need not be an inevitable attribute. Individuals can recombine in ways to mitigate this risk and to facilitate the holding of higher valued portfolios.

This sort of instrument is not now available in the retirement plan market because of the complexity in working out the details, the regulatory barriers, and the difficulty in winning acceptance among employees for such a relatively sophisticated innovation that addresses risk they may not be aware of. My proposal is for the Department of Labor to initiate a rulemaking to explore whether employers should be required, as a condition for obtaining regulatory clearance in their offering of a defined contribution plan, to offer an all equity portfolio with a "pension equity collar." The goal is to spur market innovation that will expand employees' retirement savings choices and avoid unnecessary individual risk bearing.